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CURRENT TAX ISSUES AFFECTING RELIGIOUS ORGANIZATIONS

HOWARD M. SCHOENFELD, ESQ.*

I. INTRODUCTION

The U.S. Treasury Department recently proposed changes to the Internal Revenue Code that, if enacted, would affect tax exempt organizations. This piece focuses on two tax issues related to the proposed changes which may have a significant impact on religious organizations, and is based upon a discussion of issues before the Diocesan Attorneys Association in May, 1994. The issues are still current, however, at the time of publication, the proposals are intermediate.

II. HISTORICAL BACKGROUND

In order to better understand the tax issues and their underlying reasoning, some history is helpful. Two matters are central to an understanding of current events. One is from *The Bible*, and the other is from a relatively recent Supreme Court case.

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A. A Biblical Perspective

The first example is derived from the Joseph story in the book of Genesis.¹ The Pharaoh of Egypt had two dreams which troubled him.² In his first dream, the Pharaoh stood by the Nile while seven fat, sleek calves came up out of the river.³ Subsequently, seven thin, bony calves emerged from the river and consumed the seven fat calves.⁴ In his second dream, seven thin, withered heads of grain swallowed seven full, ripe heads of grain.⁵ These dreams worried the Pharaoh, so he consulted all the wise men and magicians in Egypt but no one could explain them to him.⁶

Then the Pharaoh's cup bearer told the Pharaoh that Joseph had correctly interpreted the cup bearer's dream while he was in prison.⁷ The Pharaoh sent for Joseph and asked him the meaning of his two dreams.⁸ Joseph said that the meaning of the dreams was one and the same: there will be seven years of plenty followed by seven years of famine.⁹ Joseph told the Pharaoh he should appoint officials to impose a flat tax of twenty percent on the produce of the land during the years of plenty to serve as a reserve for the years of famine.¹⁰

Joseph so impressed the Pharaoh that he appointed him the governor over all Egypt.¹¹ Just as Joseph had predicted, seven

¹ *Genesis* 37:2-50:26. Jacob's favorite wife Rachel was Joseph's mother. *Genesis* 29:30, 30:23-24. Joseph's brothers, out of jealousy, sold him as a slave to Midianite traders. *Genesis* 37:28. The traders, in turn, sold Joseph to Potiphar, the Captain of the Pharaoh's guard. *Genesis* 37:36. Potiphar's wife, who was angry because Joseph refused her advances, claimed Joseph attempted to rape her. *Genesis* 39:11-18. Potiphar arrested Joseph and imprisoned him because he had insulted his wife. *Genesis* 39:19-20.

² *Genesis* 41:1-7.

³ *Genesis* 41:1-2.

⁴ *Genesis* 41:3-4.

⁵ *Genesis* 41:5-7.

⁶ *Genesis* 41:8.

⁷ *Genesis* 41:9-13. The Pharaoh was angry with his cup bearer and imprisoned him. *Genesis* 40:1-3. The cup bearer had a curious dream while in prison and told his dream to Joseph. *Genesis* 40:5-11. Joseph correctly interpreted that, in three days, the Pharaoh would pardon the cup bearer, release him and restore him to his position. *Genesis* 40:12-13, 20-22.

⁸ *Genesis* 41:14-15.

⁹ *Genesis* 41:25-32.

¹⁰ *Genesis* 41:34-36.

¹¹ *Genesis* 41:38-43.

years of famine began after seven years of plenty.¹² After the second year of famine, the conditions were so severe that the people sold their land to the Pharaoh.¹³ Joseph then gave them seed to sow the land.¹⁴ In exchange for the seed, the people gave one fifth, or twenty percent, of the harvest to the Pharaoh, keeping the remaining crop for themselves and their children.¹⁵ Realizing that Joseph's scheme would save their lives, the people agreed to pay the twenty percent tax.¹⁶ Joseph made the collection of twenty percent of the harvest "a statute concerning the land of Egypt; ... [only] the land of the priests alone did not become Pharaoh's,"¹⁷ because the Pharaoh did not buy the land owned by the priests.¹⁸ Consequently, the priests' land was exempt from the twenty percent tax.¹⁹ This exemption is a likely forerunner of our modern day exemption from tax on land or income used for exclusively religious purposes.²⁰

Several questions come to mind concerning the enforcement of Joseph's twenty percent tax. How did Joseph know when the people paid their taxes? Did he determine a time limit? Were there accompanying forms to complete? Did Joseph appoint a Commissioner of Internal Revenue? What happened if the land owned by the priests was leased to non-priests? As these questions clearly display, the necessary relationship between schemes of taxation and accompanying exemptions from tax is literally ancient history.²¹

B. The Supreme Court View

The second historical matter concerns a modern day consti-

¹² *Genesis* 41:53-54.

¹³ *Genesis* 47:18-20.

¹⁴ *Genesis* 47:23.

¹⁵ *Genesis* 47:24.

¹⁶ *Genesis* 47:25.

¹⁷ *Genesis* 47:26.

¹⁸ *Genesis* 47:22,26. The priests did not have to sell their lands because the Pharaoh gave them an allowance of food on which to live. *Genesis* 47:22.

¹⁹ See *Genesis* 47:26.

²⁰ I.R.C. § 501 (West 1995) (stating that organizations operated exclusively for religious purposes are exempt from taxation).

²¹ Cf. THE NEW JEROME BIBLICAL COMMENTARY 41 (Raymond E. Brown et al. eds., 1990). Although little is known about the economic history of Egypt, an exemption enjoyed by priests from the income tax is quite plausible. *Id.* However, Bible critics do not generally consider Scripture actual history, but rather as "traditions" which incorporate historical points into theology. See *id.* at 3-4.

tutional question faced by the Supreme Court in 1983. In *Regan v. Taxation With Representation of Washington*,²² the Supreme Court dealt with the constitutionality of the "substantial part" test which limits lobbying activities by certain types of non-profit organizations.²³ Section 501(c)(3) of the Internal Revenue Code, which identifies the substantial part test, grants tax exemptions to certain non-profit organizations which do not substantially engage in activities consisting of the dissemination of propaganda or other attempts to influence legislation.²⁴ In addition, section 501(c)(3) organizations are eligible to receive deductible contributions under section 170(c)(2) of the Internal Revenue Code.²⁵ In its suit, *Taxation With Representation of Washington* ("TWR") made a frontal assault on the constitutionality of the substantial part test.²⁶

²² 461 U.S. 540 (1983).

²³ *Id.*

²⁴ I.R.C. § 501(c)(3) (West 1995). The relevant portion of the statute prohibits a substantial part of the activities of the organization from including the carrying on of propaganda and attempting to influence legislation. This lobbying restriction is distinct from the absolute prohibition on political or electioneering activity, which is defined as participating or intervening in (including the publishing or distribution of statements) any political campaign on behalf of or in opposition to any candidate for public office. *Id.*

Additionally, section 501 (c)(4) of the Code grants tax exempt status to certain social welfare organizations. I.R.C. § 501 (c)(4) (West 1995). Civic organizations organized exclusively for social welfare and local associations of employees which are devoted exclusively to charitable, educational or recreational purposes are exempt from taxation. *Id.* 501 (c)(4) organizations, unlike 501 (c)(3) organizations, have no limit on the amount of lobbying they may undertake. *See id.; cf.* I.R.C. § 501 (c)(3) (West 1995). However, 501 (c)(4) organizations cannot receive tax deductible contributions from their donors. *See* I.R.C. § 170 (c)(2) (West 1995) (stating that organization disqualified under § 501 (c)(3) may not receive tax deductible contributions).

²⁵ I.R.C. § 170(c)(2) (West 1995). This section specifically limits the receipt of deductible contributions to organizations which are not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation or for participation in any political campaign on behalf of any candidate for public office. *Id.*

²⁶ *Regan v. Taxation With Representation of Washington*, 461 U.S. 540 (1983). TWR is a nonprofit organization which was formed to take over the operation of two other nonprofit organizations, one of which had tax-exempt status under I.R.C. § 501(c)(3) and the other under I.R.C. § 501(c)(4). *Id.* at 540. The Internal Revenue Service denied TWR's application for tax exempt status under § 501(c)(3) because it appeared that a substantial part of TWR's activities consisted of attempting to influence legislation, which is violative of § 501(c)(3). *Id.* at 542. TWR then brought suit in federal court seeking a declaratory judgment that it qualified for the tax exemption provided by § 501(c)(3). *Id.*

The organization raised two challenges.²⁷ First, TWR claimed that there was a violation of its First Amendment rights to free speech.²⁸ TWR, desiring to lobby without limitation but restricted by the substantial part test, claimed this restriction constituted a violation of Free Speech under the First Amendment.²⁹ Second, TWR argued that there was a violation of the Equal Protection component of the Fifth Amendment's Due Process Clause.³⁰ TWR pointed out that section 501(c)(19) veterans organizations can receive deductible contributions without lobbying limitations.³¹ The D.C. Court of Appeals agreed with the taxpayer.³² However, after asserting probable jurisdiction,³³ the Supreme Court ruled in favor of the Internal Revenue Service and held that the substantial part test is constitutional.³⁴ The importance of this case rests in the Supreme Court's rationale. The Court pointed out that one must understand how tax laws are written and how Congress might write future tax laws. The Supreme Court, in order to evaluate TWR's claims, analyzed the tax exemption scheme enacted by Congress.³⁵ The Supreme Court said:

²⁷ *Id.* at 542. TWR claimed that the prohibition against substantial lobbying was unconstitutional under the First Amendment and the equal protection component of the Fifth Amendment's Due Process Clause. *Id.*

²⁸ *Id.* at 545. TWR based its First Amendment argument on *Speiser v. Randall*, 357 U.S. 513, *reh'g denied*, 358 U.S. 860 (1958). *Id.* The Supreme Court held in *Speiser* that it was unconstitutional, under the First Amendment, to deny a property tax exemption to a person who refused to sign a declaration against advocating the overthrow of the U.S. government. *Speiser*, 357 U.S. at 518.

²⁹ See *Regan*, 461 U.S. at 545. But see *Cammarano v. U.S.*, 358 U.S. 498 (1959) (stating that government need not allow lobbying expenses to be tax deductible under allowance for ordinary business expense and, in effect, government need not subsidize lobbying).

³⁰ *Regan*, 461 U.S. at 546.

³¹ *Id.* at 546-47. Section 501(c)(19) defines veteran's organizations as those organized within the U.S. or its possessions, having a membership that is at least 75 percent past or present members of the U.S. Armed Forces and a substantial portion of the remaining membership having some connection to the U.S. Armed Forces, and with no part of its earnings which inures to the benefit of any private individual. I.R.C. § 501(c)(19) (West 1995).

³² *Taxation With Representation of Washington v. Regan*, 676 F.2d 715, 741-42 (D.C. Cir. 1982), *rev'd*, 461 U.S. 540 (1983) (accepting TWR's Due Process claim). However, the D.C. Court of Appeals rejected the First Amendment claim. *Id.* at 726.

³³ *Regan v. Taxation With Representation of Washington*, 459 U.S. 819 (1982).

³⁴ *Regan*, 461 U.S. at 546 (finding no violation of First Amendment); *id.* at 549 (rejecting Fifth Amendment Due Process claim).

³⁵ *Regan*, 461 U.S. at 544.

Both tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would otherwise have to pay on its income. Deductible contributions are similar to cash grants of the amount of a portion of the individual's contributions. The system Congress has enacted provides this kind of subsidy to non-profit civic welfare organizations generally, and an additional subsidy to those charitable organizations that do not engage in substantial lobbying. In short, Congress chose not to subsidize lobbying as extensively as it chose to subsidize other activities that nonprofit organizations undertake to promote the public welfare.³⁶

The Supreme Court, in effect, said that as long as Congress had a rational tax classification scheme, one that was related to a legitimate governmental purpose, it was constitutional under both the First Amendment, and the Equal Protection component of the Fifth Amendment's Due Process Clause.³⁷ Essentially, tax-exempt status and deductibility of contributions are a matter of legislative grace.³⁸ They are a privilege and not a right.

III. CURRENT TREASURY PROPOSALS AND NEW REQUIREMENTS AFFECTING CHARITABLE ORGANIZATIONS

The TWR discussion provides the background for several matters of utmost importance to tax-exempt organizations, particularly religious organizations. On March 16, 1994, the Assis-

³⁶ *Id.* (footnote omitted). Commentators view the tax exemption as an implicit subsidy to the organization equal to the amount of taxes unpaid due to the exemption. See, e.g., John D. Colombo, *Why is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 857 (1993); *Developments in the Law: Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1620 (1992). The courts have also recognized the subsidy theory. See, e.g., *Rosenberger v. University of Virginia*, 1995 U.S. LEXIS 4461, *74 (Thomas, J., concurring) (stating exemptions from tax act as subsidies); *Davis v. Michigan Department of the Treasury*, 489 U.S. 803, 824 (1989) (explaining state employees receive subsidy through tax exemption). Despite the analogy, tax exemptions are not an exact equivalent of a cash subsidy. *Walz v. Tax Comm'n of New York*, 397 U.S. 664, 674-76 (1970).

³⁷ *Regan*, 461 U.S. at 547. Due to the legislature's broad discretion in the field of taxation one needs to show a "hostile and oppressive" discrimination within the regulation while negating any "conceivable basis" proposed to support the regulation. *Madden v. Kentucky*, 309 U.S. 83, 87-88 (1940).

³⁸ *Regan*, 461 U.S. at 549 (citing *Commissioner v. Sullivan*, 356 U.S. 27, 28 (1958)).

tant Secretary for Tax Policy went before Congress to introduce several Treasury proposals³⁹ that will significantly affect religious organizations on a variety of levels.⁴⁰ These proposals make sense in light of current statistics. According to recent I.R.S. records, there are 1.1 million tax-exempt organizations, not including possibly several hundred thousand churches and small organizations.⁴¹ There are about 489,000 public charities that file returns.⁴² These returns indicate that the revenues of public charities total \$406 billion, their assets total \$674 billion and their charitable contributions total \$80 billion.⁴³ Furthermore, the activities of these organizations represent seven percent of the domestic gross product.⁴⁴ Obviously, a member of Congress, studying tax subsidies and tax expenditures, would have reason to scrutinize the tax subsidy on the \$80 billion of tax-exempt

³⁹ See 140 CONG. REC. D 260, 266-67 (daily ed. Mar. 16, 1994) (recognizing subcommittee hearing); *Prepared Statement*, *infra* note 40, at 51 (presenting text of statement made by Leslie B. Samuels, Assistant Secretary for Tax Policy).

⁴⁰ The Treasury proposals were meant to allow the IRS to impose milder sanctions than simply revocation of tax-exempt status for any violations. See Irwin M. Birbaum & Jacob I. Friedman, *Proposals Allow IRS to Impose Milder Penalties; Sanctions on Tax-Exempt Institutions*, N.Y.L.J. Aug. 8, 1994, at 5. Specifically, the proposals seek to improve compliance by tax-exempt organizations through: a tax on "excessive benefits" to organization insiders; penalties for failing to meet Form 990 requirements; requiring organizations to make copies of their Form 990 available upon request; requiring additional information to be provided on Form 990; and requiring organizations to disclose their donors the tax-deductibility of any contributions. *Prepared Statement by Leslie B. Samuels, Assistant Treasury Secretary for Tax Policy, Before House Ways and Means Oversight Subcommittee Hearing on Tax Compliance by Charitable Organizations March 16, 1994 (Text)*, BNA DAILY TEX REP., Mar. 17, 1994, § L, at 51 [hereinafter *Prepared Statement*]. The House Ways and Means Committee agreed with the recommendations in the proposal. *House Ways and Means Oversight Subcommittee Letter and Report to Full Committee on Reforms to Improve the Tax Rules Governing Public Charities. Issued March 9, 1994 (Text)*, BNA DAILY REPORT FOR EXECUTIVES, May 10, 1994, § L, at 88.

⁴¹ 139 CONG. REC. H10622, 10623 (1993) (stating that in 1990 there were over one million § 501(c) tax-exempt organizations and estimated 340,000 churches not included in this figure).

⁴² *Id.* (estimating 489,000 tax-exempt organizations filed tax returns in 1990).

⁴³ *Id.*; *IRS Looking into Tax Exemption Abuses*, ROCKY MOUNTAIN NEWS (Denver), June 20, 1995, at 38A (estimating non-profit organizations raise nearly \$700 billion annually).

⁴⁴ 139 CONG. REC. H10622, 10623 (1993) (recognizing charitable organizations as contributing 7.4 percent of GDP, according to 1990 figures); *IRS Looking into Tax Exemption Abuses*, *supra* note 43, at 38A (estimating contribution to GDP as about 10 percent).

revenues generated by charitable contributions.⁴⁵

Congress' concern in this area arose for a number of reasons and was primarily the result of abuses by a few tax-exempt organizations.⁴⁶ These abuses in turn spurred Congressional interest in finding an appropriate remedy since most charitable organizations do perform very important philanthropic activities⁴⁷ and play a vital part in the pluralistic system of the United States.⁴⁸ Thus, the Treasury proposals and the IRS complaints do not focus on the general population of charitable and religious organizations, but rather on the few limited abuse cases.⁴⁹

Under current law, Congress discovered that all too often, the Treasury's only recourse against abuse cases was to penalize the organization by revoking its tax-exempt status.⁵⁰ For example, the Commissioner of Internal Revenue was asked what happens when an abuse case arises during a Subcommittee on Oversight hearing before Chairman Pickle from Texas.⁵¹ Chair-

⁴⁵ See 139 CONG. REC. H10622, 10623 (1993) (equating statistics on charitable organizations as "Big Business" which creates possibility of great abuses).

⁴⁶ See Bill McAllister, *Charities Scored on Hill for CEO Pay, Perks*, WASH. POST, June 16, 1993, § 1, at A4 (reporting abuses found by Representative Pickle's investigation of tax-exempt organizations' tax returns).

⁴⁷ See *id.* at A4 (stating that while reporting to Congress, IRS officials repeatedly maintained that most charities performed important work); *Prepared Statement*, *supra* note 43, at 51 (affirming Treasury Department belief that most charities do worthy work).

⁴⁸ *Testimony June 6, 1995 Michael J. Boskin, Professor of Economics and Senior Fellow, Tully M. Friedman, Hoover Institution, Stanford University House Ways and Means Tax Code Revision*, FED. DOCUMENT CLEARING HOUSE CONG. TESTIMONY, June 6, 1995 (testifying that charities strengthen pluralistic democracy because charitable deductions yield more for charities than Treasury actually loses); Barber Conable, *Charity's "Special Interest"*, U.S. NEWS & WORLD REP., June 10, 1985, at 102 (opining public policy has been on charities' side because they have done so much to make United States pluralistic society).

⁴⁹ *Exempt Organizations Warned to Conform to Requirements*, BNA PENSIONS & BENEFITS DAILY, Mar. 6, 1995 (announcing IRS investigation into abuses by tax-exempt organizations, especially colleges, universities and health care organizations).

⁵⁰ See *infra* note 54 and accompanying text.

⁵¹ 139 CONG. REC. H10622, 10623 (1993) (stating abuse by charities as area of particular concern). The Commissioner gave several examples of such abuses including: 1) the purchase of a 42-foot boat for an insider's personal use and leasing property to an insider without charging rent; 2) a hospital sold to a for-profit corporation run by members of the hospital board for less than fair market value; 3) a church paying for its founder's jewelry, clothing, and luxury cars; and 4) many organizations paying outrageous salaries and providing expensive vacations and homes to their executives. *Id.* at H10624.

man Pickle has a very deep and abiding interest in tax-exempt organizations⁵² and wants to make sure that taxpayers' dollars are being spent as directed.⁵³

The Subcommittee was curious to know if current IRS procedures could deal effectively with problems in this area.⁵⁴ The Commissioner testified that the IRS has particularly severe problems in administering the tax laws pertaining to public charities when issues of private inurement and private benefit arise.⁵⁵

Under the current Internal Revenue Code, any inurement of net earnings to private individuals can result in the loss of 501(c)(3) status.⁵⁶ 501(c)(3) organizations must exclusively serve the public as opposed to private interests.⁵⁷ If an organization is found to have allowed its net earnings to inure to a private individual or to have served substantial private interests there is only one sanction available to the IRS under the Internal Revenue Code—revocation of tax-exempt status.⁵⁸ The loss of tax-exempt status means that the organization can no longer receive

⁵² Pickle took a "vow" to do something about tax-exempt organization abuses. Bruce D. Collins, *So You Say You Want a Revolution? It's Coming*, CORP. LEGAL TIMES, Sept. 1993, at 6.

⁵³ Congressman Pickle expressed concern that contributions were being used to benefit certain insiders within the charities rather than benefitting the charities themselves. *Pickle, Richardson Say More Tools Needed to Enforce Exempt Status Laws*, BNA PENSION & BENEFITS REPT., June 21, 1993.

⁵⁴ See 139 CONG. REC. H10622 (1993) (indicating that IRS needs tools to identify and sanction acts of private inurement because current IRS procedures may not be effective).

⁵⁵ *Federal Tax Laws Applicable to the Activities of Tax-Exempt Charitable Organizations: Hearing Before the Subcommittee on Oversight of the House of Representatives Committee on Ways and Means*, 103rd Cong., 1st Sess. 9 (1993) [hereinafter *June, 1993 Hearings*] (testimony of Margaret Milner Richardson, Commissioner of Internal Revenue, stating "both the inurement and the private benefit rules present difficulties for effective tax administration").

⁵⁶ I.R.C. § 501(c)(3) (West Supp. 1995) ("[N]o part of the net earnings of which inures to the benefit of any private shareholder or individual ..."); Treas. Reg. § 1.501(c)(3)-1(c)(2) (1995) (providing that organizations do not meet operational test if their net earnings "inure in whole or part to the benefit of private" individuals).

⁵⁷ Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1995). See, e.g., *Church of Scientology of California v. C.I.R.*, 823 F.2d 1310 (9th Cir. 1987), cert. denied, 486 U.S. 1015 (1988) (holding that organizations will lose their tax-exempt status even if small part of their income is inured to private individuals).

⁵⁸ I.R.C. § 503(a) (West Supp. 1995). See also *June, 1993 Hearings*, supra note 55, at 11 ("Under current law, the sanction for violation of any provision is revocation of an organization's exemption.").

deductible contributions.⁵⁹ Furthermore, the loss of tax-exempt status can affect much more than just the 501(c)(3) organization itself. A recent example cited by the Commissioner illustrates the far-reaching implications of losing tax-exempt status.⁶⁰

Assume that an examination by a revenue agent reveals that a large university is providing its president with inappropriate benefits. The university may be paying the president a salary that appears to be excessive in comparison to salaries paid to presidents of comparable universities. Also, the university may have provided the president with a substantial interest-free loan or it may have paid for costly and luxurious amenities in the president's official residence. Each of these facts would raise serious inurement questions. Revoking the university's exemption, however, may provide an inappropriate penalty.⁶¹ Revocation could adversely affect the entire university community, including employees, students and area residents.⁶² For instance, an employee of a section 501(c)(3) organization is eligible for a 403(b) retirement benefit.⁶³ This is a special benefit available to employees of schools and other section 501(c)(3) organizations.⁶⁴ However, if the 501(c)(3) organization loses its exemption status, its employees could find themselves also losing their 403(b) retirement plan without having committed any wrong.⁶⁵ Similarly, investors who hold tax-exempt bonds issued by a section 501(c)(3) hospital or university which loses its tax-exempt status, could find themselves with significant tax prob-

⁵⁹ See generally I.R.C. § 170(a)(1) (West Supp. 1995) (stating requirements of organizations in order to receive deductible contributions); *id.* §§ 6113, 6710 (stating requirements of charitable organizations to disclose non-deductibility of contributions and penalties for failure to disclose).

⁶⁰ *June, 1993 Hearings, supra* note 55, at 18-19 (prepared statement of Hon. Margaret Milner Richardson, Commissioner of Internal Revenue).

⁶¹ *June, 1993 Hearings, supra* note 55 at 18-19.

⁶² *U.S. Department of the Treasury's Proposals to Improve Compliance by Tax-Exempt Organizations: Hearing Before the Subcommittee on Oversight of the House of Representatives Committee on Ways and Means, 103rd Cong., 2nd Sess. 9 (1994) [hereinafter March, 1994 Hearings]* (testimony of Hon. Leslie B. Samuels, Assistant Secretary for Tax Policy, Department of the Treasury).

⁶³ I.R.C. § 403(b) (West Supp. 1995). Amounts contributed to annuity plans are purchased by the employees of § 501(c)(3) organizations are "excluded from the gross income of the employee for the taxable year" *Id.* § 403(b)(1)(E).

⁶⁴ See *id.* § 403(b).

⁶⁵ See *Treas. Reg. § 1.403(b)-1(e)(4) (1995)* (status of employer implicates 403(b) benefits of employee).

lems because the interest on the bonds would no longer be excludable from their income.⁶⁶

In short, the Service is often faced with the difficult choice of either revoking an organization's tax exemption, with all the inappropriate tax consequences that follow, or taking no enforcement action so long as the compensation in question has been recorded accurately on the individual taxpayer's return.⁶⁷ This is obviously not the most effective way to administer the tax laws. The Commissioner of Internal Revenue, in fact, pointed out that problems such as this do not permit "fair and equitable"⁶⁸ tax administration; they do not provide any certainty of consequences for misconduct; and they certainly do not place penalties on the wrongdoer.⁶⁹

Between June 1993 and March 1994, the Treasury Department developed proposals to introduce intermediate sanctions as an alternative to the revocation of tax-exempt status.⁷⁰ These proposals were introduced on March 16, 1994.⁷¹ The proposals refer to problems in administering current law and look to the private foundation rules as a useful framework to provide a standard for tax-exempt organizations.⁷²

The 1969 private foundation rules enacted comprehensive, tiered excise taxes dealing with specific spheres of conduct.⁷³ If a violation occurs, an excise tax is placed upon the wrongdoer in

⁶⁶ See I.R.S. News Release, IR-90-60 (April 3, 1990) (warning against potentially abusive transaction which may result in loss of tax-exempt status leading to taxation on interest paid by bonds issued by 501(c)(3) organizations and hospitals).

⁶⁷ *June, 1993 Hearings*, *supra* note 55, at 19.

⁶⁸ *June, 1993 Hearings*, *supra* note 55, at 13.

⁶⁹ See *June, 1993 Hearings*, *supra* note 55, at 11 (testimony of Commissioner stating that "[u]nder current law, ... revocation of such an organization's exemption does not adequately focus punishment on the abusers.").

⁷⁰ See *June, 1993 Hearings*, *supra* note 55; *March, 1994 Hearings*, *supra* note 62. The proposals apply to § 501(c)(4) organizations as well as § 501(c)(3) organizations. *March, 1994 Hearings*, *supra* note 62, at 11. See also I.R.C. § 501(c)(4) (West Supp. 1993) (explaining what types of organizations are granted 501(c)(4) status); see also 26 U.S.C. § 501(c)(3) (1988) (explaining what types of organizations are 501(c)(3) organizations).

⁷¹ *March, 1994 Hearings*, *supra* note 62, at 1-26.

⁷² See *March, 1994 Hearings*, *supra* note 62.

⁷³ See I.R.C. § 4963 (West Supp. 1995) (providing definitions of first and second tier excise taxes); see generally, *id.* § 4941(a)(1) (imposing excise tax on self-dealing between disqualified persons and private foundations; *id.* § 4942(a) (imposing excise tax on undistributed income); *id.* § 4944(a)(1) (imposing excise tax on investments which jeopardize charitable purposes).

the transaction.⁷⁴ An opportunity for correction is provided, and⁷⁵ if a correction is not made, a higher level tax may be imposed.⁷⁶ Furthermore, there are very severe penalties for willful, flagrant, or repeated misconduct.⁷⁷ While these private foundation rules create a very complicated tax regime, the regime is an efficient one since according to all the data available to the Internal Revenue Service, private foundations are among the most compliant category of taxpayers in the United States.⁷⁸ The high compliance rate among private foundations is not surprising considering the very severe penalties that can befall the persons responsible for malfeasance.⁷⁹ The Treasury proposals thus incorporate the private foundation rules as a useful frame of reference.⁸⁰

As to the exact details of the proposed tax scheme, the United States Department of the Treasury has taken the position that problems with regard to private inurement and private benefit generally can be dealt with as excess fair-market-value transactions.⁸¹ This means that those in control of the organiza-

⁷⁴ See *id.* § 4941(b)(1) (imposing 200% tax on disqualified person if self-dealing is "not corrected within the taxable period"); *id.* § 4941(b)(2) (imposing a 50% tax on foundation manager involved in self-dealing who refuses to be part of correction). See also Treas. Reg. § 53.4941(a)-1(a) (1995).

⁷⁵ See I.R.C. § 4941 (West Supp. 1995). To "correct" is defined as "undoing the transaction to the extent possible, but in any case placing the private position in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards." *Id.* § 4941(e)(3). The Code also provides, in certain cases, abatement of first and second tier taxes upon correction of a taxable event. *Id.* §§ 4961, 4962. The period of correction is 90 days subject to special rules. *Id.* § 4963(e)(1). See also Treas. Reg. § 53.4941(e)-1(c)(1) (1995).

⁷⁶ See *supra* note 74 (relevant Code and regulation sections pertaining to excise taxes).

⁷⁷ I.R.C. § 6684 (West Supp. 1995). An additional penalty equal to the amount of the tax for persons who are liable for tax relating to private foundations is imposed if such persons are found "by reason of any act or failure to act which is not due to reasonable cause and either" repeated or "willful and flagrant." *Id.*

⁷⁸ Chih-Chin Ho, *Form 990-T Compliance*, in INTERNAL REVENUE RESEARCH BULLETIN Pub. No. 1500, 47, 48 (1992). Cf. *June, 1993 Hearings*, *supra* note 55, at 72 (stating that study should be qualified because of "environment in which private foundations operate").

⁷⁹ See *supra* notes 74-76 (relevant Code and regulation sections for penalties and additional taxes).

⁸⁰ *March, 1994 Hearings*, *supra* note 62, at 12.

⁸¹ See *March, 1994 Hearings*, *supra* note 62, at 16-23 (discussing June 15, 1993 and August 2, 1993 hearings and explaining proposal to treat problems of private inurement, among insiders of charitable organizations as excess fair market value transactions).

tion,⁸² fiduciaries of the organization, cause it to enter into a transaction not at fair market value, to the detriment of the organization and to the benefit of themselves.⁸³ The Treasury proposal focuses on the excess taxable benefit, which means the excess of the fair market value that is paid or received by an organization over the value of the goods or services provided.⁸⁴ Examples of payments made in excess of the fair market value of services received which would be subject to this kind of tax include items that are not paid as reasonable compensation—typically yachts, limos, maid service and interest-free loans (not paid as compensation).⁸⁵ Once it is determined that there is an excess taxable benefit, a twenty-five percent tax would accrue under the Treasury proposal.⁸⁶ Unlike the revocation of tax-exempt status, the penalty does not fall on the section 501(c)(3) organization, but rather on its officers, directors, trustees or any other person in a position to substantially influence its financial affairs.⁸⁷ It is intended that this penalty scheme will attract attention to the person benefiting from such transactions thus acting as a deterrent to other would-be offenders.⁸⁸ Like the private foundation rules, there is an opportunity for abatement if there is a correction,⁸⁹ and there is a 200 percent tax if the excess benefit is not corrected.⁹⁰

Under the Treasury proposal, the sole sanction for an inappropriate benefit would be the imposition of the excise tax,⁹¹ the

⁸² See *March, 1994 Hearings*, *supra* note 62, at 20. Individuals in control of the organization would include: "(i) the officers, directors, and trustees ... and (ii) those otherwise in a position to exercise substantial influence over the organization's affairs." *Id.*

⁸³ See *March, 1994 Hearings*, *supra* note 62, at 20.

⁸⁴ See *March, 1994 Hearings*, *supra* note 62, at 20. "[A] non-fair market value transfer [is one] in which an insider pays inadequate consideration for property transferred, leased, licensed or loaned by the organization, or the organization pays excessive consideration for property transferred, leased, licensed, or loaned by the insider." *Id.*

⁸⁵ See *June, 1993 Hearings*, *supra* note 55, at 11.

⁸⁶ See *March, 1994 Hearings*, *supra* note 62, at 11-12.

⁸⁷ See *March, 1994 Hearings*, *supra* note 62, at 11-12.

⁸⁸ The purpose of the Treasury proposals is to deter insiders from using their positions to receive unreasonable compensation and to involve the organization in non-fair market value transfer resources. See *March, 1994 Hearings*, *supra* note 62, at 26.

⁸⁹ See *March, 1994 Hearings*, *supra* note 62, at 22.

⁹⁰ See *March, 1994 Hearings*, *supra* note 62, at 22.

⁹¹ See *March, 1994 Hearings*, *supra* note 62, at 22. *But see infra* note 104 and

intermediate sanction,⁹² so long as the organization is determined to be capable of having the fundamental character of a charitable organization.⁹³ This means that as long as the organization is doing what it is supposed to be doing—running a hospital, running a school or running a university—the sole sanction that is available for an insider's misconduct would be the imposition of an intermediate sanction upon the insiders of the organization.⁹⁴

The following illustration provides an example of how the Treasury intends the excise tax to apply. Assume that a section 501(c)(3) organization provides health care in a clinic setting.

The organization's board of directors is controlled by the CEO and a small number of persons with whom the CEO of the organization itself have substantial business dealings. The total compensation package of the CEO exceeded \$1 million. The organization also made substantial credit card payments and cash disbursements for personal expenditures, including liquor, china, perfume, crystal, theater and airline tickets.

The CEO's compensation would be an excess benefit, subject to excise tax, to the extent that it was determined to be unreasonable. The unreasonableness of the CEO's compensation would be assessed looking at all of the facts and circumstances, including the nature of the CEO's duties and the compensation paid by similar organizations to those who perform similar duties. The means by which the organization determined the compensation it paid the CEO would also be relevant. In this case, although the organization's board presumably approved the CEO's salary, the facts suggest that the board is not truly independent. The CEO appears to have substantial influence over the board. Therefore, even assuming that the board approved the compensation, that fact would be given very little weight in this particular case.⁹⁵ The portion of the CEO's compensation

accompanying text (explaining caveat to excise tax as being sole sanction).

⁹² See *supra* note 69 and accompanying text (explaining that U.S. Department of the Treasury proposed intermediate sanction as alternative to options of either doing nothing or revoking organization's tax-exempt status).

⁹³ See *March, 1994 Hearings, supra* note 62, at 22 (stating that if excess benefit is so egregious that organization can no longer be viewed as charitable, then organization would be subject to revocation of tax exemption in addition to imposition of excise tax).

⁹⁴ See *March, 1994 Hearings, supra* note 62, at 22.

⁹⁵ *March, 1994 Hearings, supra* note 62, at 23.

that is determined to be unreasonable would also be the portion subject to tax.⁹⁶

In addition to an excise tax, the Treasury proposals set forth an exit tax that is analogous to the anti-abuse provision for private foundations.⁹⁷ This exit tax would prevent an organization from dropping its status as a charitable organization simply to escape imposition of the tax.⁹⁸ Thus, if an organization wanted to dissolve, reorganize or restructure, it would still be subject to an exit tax.

In addition to the proposed excise and exit taxes discussed above, the proposals also include certain increased disclosure requirements.⁹⁹ Since 1950, it has been a Congressional policy decision that publicity through disclosure is a check against potential abuses.¹⁰⁰ For example, some organizations may file Form 990¹⁰¹ returns. The Form 990 is a public disclosure vehicle which is available to the general public, like an interested taxpayer or even a newspaper reporter.¹⁰² Currently, the penalty for failing to file IRS Form 990 timely, accurately, or completely, is \$10 a day up to a maximum of \$5,000 per year, regardless of the size of the organization.¹⁰³ Consequently, if an organization does not want to report the salary of its CEO or board members, or report a certain transaction, it can always avoid doing so by simply paying \$5,000.¹⁰⁴ This troubled the Internal Revenue Service and Congress.¹⁰⁵ In order to promote compliance, the

⁹⁶ See *March, 1994 Hearings, supra* note 62, at 23.

⁹⁷ See *March, 1994 Hearings, supra* note 62, at 23.

⁹⁸ See *March, 1994 Hearings, supra* note 62, at 13.

⁹⁹ See *March, 1994 Hearings, supra* note 62, at 13.

¹⁰⁰ See Senate Committee on Finance, Revenue Act of 1950, S. Rep. No. 2375, 81st Cong., 2nd Sess. 33 (1950), reprinted in 190 U.S.C.C.A.N. 3053, 3087, and in 116 United States Revenue Acts, 1909-1950, The Laws, Legislative Histories & Administrative Documents, 164 (1950).

¹⁰¹ See I.R.C. § 6033 (West Supp. 1995); Treas. Reg. § 1.6033-1(a)(2) (1995) (requiring certain tax-exempt organizations to file returns on Form 990).

¹⁰² See *March, 1994 Hearings, supra* note 62 at 13-14.

¹⁰³ See I.R.C. § 6652(c) (West Supp. 1995).

¹⁰⁴ See *supra* text accompanying note 103 (explaining that maximum penalty for not disclosing CEO's or board members salary is not to exceed lesser of \$5,000 or 5 percent of gross receipts for year).

¹⁰⁵ See generally *June, 1993 Hearings, supra* note 55 at 53-72 (question and answer session, between members of Subcommittee on Oversight of the House Committee on Ways and Means and members of I.R.S., concerning non-compliance with requirement of filing 990 tax form). Interestingly, a member of Congress actually did his own survey with regard to compliance by tax-exempt organizations in the

Treasury is proposing to increase the costs of non-compliance.¹⁰⁶ Under the Treasury proposal, the \$10 daily penalty for failure to file Form 990 becomes \$100 and the \$5,000 maximum penalty becomes \$50,000.¹⁰⁷ It is submitted that the proposed penalties should increase compliance, especially by those organizations which treat the current penalties as ordinary operating costs.

The Treasury proposals also contain additional rules regarding the solicitation of contributions.¹⁰⁸ Historically, the public has been confused by organizations that are simply nonprofit, *nonexempt* organizations that solicit contributions under the public's perception of tax deductibility.¹⁰⁹ Since contributions made to nonprofit, nonexempt organizations are not deductible,¹¹⁰ the proposals require that these organizations make a disclosure to this extent.¹¹¹

Another facet of the Treasury proposals is a provision regarding the availability of disclosures made on Form 990 to the public.¹¹² Under present law, if a member of the public wants to review an organization's Form 990, it has to be made available during regular business hours,¹¹³ the charity is not obligated to

Washington area. He sent out a staff member to request Form 990, which he is entitled to do during regular business hours. *See* I.R.C. § 6104(e) (West Supp. 1995). The results of the survey indicated that there was a very high degree of non-compliance by those organizations.

¹⁰⁶ *See March, 1994 Hearings, supra* note 62, at 8. The proposed penalties of \$100 per day, up to a maximum \$50,000 per tax return would be for organizations with gross annual receipts exceeding \$1 million. Organizations with gross receipts of \$1 million or less would be subject to penalties of \$20 per day, with the maximum penalty limited to the lesser of \$10,000 or 5 per cent of the organization's gross annual fees. *Id.*

¹⁰⁷ *See March, 1994 Hearings, supra* note 62, at 8.

¹⁰⁸ *See March, 1994 Hearings, supra* note 62, at 8.

¹⁰⁹ Charitable deductions generally are allowed for (1) contributions to organizations that are organized and operated exclusively for charitable, educational, religious, scientific, or certain other specified purposes, I.R.C. § 170(c)(2), (2) contributions by individuals to certain fraternal organizations if such contributions are to be used exclusively for charitable, etc. purposes, *Id.* § 170(c)(4)), and (3) contributions to certain veterans organizations, *Id.* § 170(c)(3).

¹¹⁰ I.R.C. § 6613 (1988) requires tax-exempt organizations which are ineligible to receive tax deductible contributions to disclose this fact to potential contributors. However, nonprofit organizations which are not tax-exempt are not covered by § 6113, and thus under current law, when they solicit funds they are not required to disclose that contributions are not tax deductible.

¹¹¹ *See March, 1994 Hearings, supra* note 62, at 8.

¹¹² *See March, 1994 Hearings, supra* note 62, at 13-14.

¹¹³ I.R.C. § 6104(e) (1988) requires exempt organizations, other than private foundations, to make copies of their annual returns available for public inspection

make or mail a copy of Form 990 and the form is only available for public inspection.¹¹⁴ However, the Treasury proposal provides that the public may request copies for a reasonable fee.¹¹⁵ Further, the proposal acknowledges the possibility that some organizations will be subjected to harassment.¹¹⁶ An organization's budget for mailing, handling and processing could deplete its resources if it were flooded with requests for copies of Form 990. Therefore, there is a provision that limits the number of requests that an organization would be required to fill at any given time.¹¹⁷

Disclosure, along with substantiation, are factors taken into consideration by various new requirements recently imposed on charitable organizations.¹¹⁸ As previously mentioned, disclosure is regarded as a very powerful enforcement tool in the arsenal of the Internal Revenue Service.¹¹⁹ New rules mandating substan-

during normal business hours.

¹¹⁴ See I.R.S. Notice 88-120, 1988-48 I.R.B. 10. An organization is required to have a copy of its annual returns and exemption record available for public inspection, but it is not required to photocopy or distribute these documents to the public. *Id.*

¹¹⁵ See *March, 1994 Hearings*, *supra* note 62, at 8. The proposal would require an organization to publicize the availability of its Form 990 and to provide copies of it upon request for a reasonable fee covering reproduction and mailing costs. *Id.* Pursuant to this proposal, the Secretary of the Treasury would promulgate regulations to establish procedures for public notification of the availability of Form 990, as well as fix a price for securing such information. *Id.*

¹¹⁶ *March, 1994 Hearings*, *supra* note 62, at 8. In her testimony, Samuels recognized that requests for documents could be used to harass an organization and suggested that organizations be required to respond only to a limited number of requests in a given period. *Id.*

¹¹⁷ See *March, 1994 Hearings*, *supra* note 62, at 8.

¹¹⁸ See I.R.C. § 170(f)(8) (Supp. V 1993). This section provides that, "No deduction shall be allowed under subsection (a) for any contribution of \$250 or more unless the taxpayer substantiates the written contribution by a contemporaneous written acknowledgement of the contribution by the donee organization" *Id.* at § 170 (f)(8)(A). See also Temp. Treas. Reg. T.D. 8544, 59 Fed. Reg. 27458 (1994) (explaining § 170(f)(8) and soliciting public comment on whether transitional relief is required for 1994 contributions); I.R.S. Notice 95-15, 1995-15 I.R.B. 22 (explaining § 170(f)(8) and providing transitional relief from "contemporaneous written acknowledgment" of contribution).

¹¹⁹ See *March, 1994 Hearings*, *supra* note 62, at 8 (finding that documented cases of noncompliance by public charities demonstrated need for public scrutiny to minimize misconduct). The Tax Reform Act of 1969, Pub. L. No. 91-172, heavily regulated conduct of private foundations. The Assistant Secretary for Tax Policy, Leslie Samuels did not favor extending these regulations to include public charities because the administrative burden might hinder them in their performance of charitable functions.

tiation and disclosure arose from congressional concern about *quid pro quo* matters and charitable contributions.¹²⁰ In 1987 and 1988, when Congress was examining laws relating to lobbying and political activities, it also found that the rules governing charitable contributions, charitable solicitations and charitable deductions relating to *quid pro quo* matters resulted in uncertainty and, in some cases, abuse.¹²¹

In 1987, Congress expressed concern that charitable organi-

¹²⁰ For example, the growing use of scrip for fund-raising purposes has led to the abuse of the system. Scrip, or grocery coupons, is a trend made popular in recent years by California and other grocers. Its use has grown to encompass hundreds of businesses, schools, religious organizations and nonprofit institutions. The I.R.S. claims that some individuals are violating the law by claiming that scrip payments are deductible contributions. See Galvin Power, *Catholic Diocese the Biggest Player, Fund-Raisers' Dream Tool - Scrip*, SAN FRANCISCO CHRONICLE, May 9, 1995 at A1. Non-profit organizations would raise money by purchasing scrip certificates from businesses below face value and then reselling the same certificates at face value to members. *Id.* To be sure, the IRS San Francisco office put out a major alert advising purchasers that scrip is not a charitable contribution because purchasers receive something in return for use of the coupon. Other questionable charitable contributions are those which involve solicitations that do not indicate the fair market value of the benefit conferred. A \$150 ticket to a dinner may state: "Contributions deductible to the extent provided by law." A television ad may promise "If you make your tax-deductible pledge today in the amount of \$100, you will receive a leather-bound gilt-edged volume of the Internal Revenue Code. For \$50 more, you will get a matching set of the Federal Tax Regulations." These are but a few examples of questionable charitable solicitations that may not be deductible at all. Rev. Rule. 67-246, 1967-2 C.B. 104 includes examples of charitable solicitations involving *quid pro quo*, that are non-deductible in whole or in part. In general, if the soliciting organization does not indicate the fair market value of the benefit conferred, the entire contribution is not deductible. *Id.*

¹²¹ H.R. REP. No. 391(II), 100th Cong., 1st Sess. (1987), reprinted in 1987 U.S.C.C.A.N. 2313-378 (discussing, for example, membership solicitations which implied that entire contribution was tax deductible although contributor received benefit); 134 CONG. REC. H276 (daily ed. Feb. 9, 1988) (statement of Rep. Pickle) (discussing disclosure requirements for non-charitable tax-exempt organizations); 133 CONG. REC. H6362 (daily ed. July 15, 1987) (statement of Rep. Pickle) (discussing lack of compliance by exempt organizations regarding public disclosure of lobbying and political activity); I.R.S. News Release IR-88-31 (Feb. 10, 1988) (covering disclosure requirements of non-charitable tax-exempt organizations); see also I.R.C. § 6115 (Supp. V 1993) (addressing disclosure for *quid pro quo* contributions to charitable organizations), Rev. Proc. 92-49, 1992-26 I.R.B. 18 (extending Rev. Proc. 90-12, 1990-1 C.B. 471); Rev. Proc. 90-12, 1990-1 C.B. 471 (providing guidelines on deductibility when contributors receive something in exchange for contribution); Rev. Proc. 86-63, 1986-1 C.B. 88 (regulating payments to athletic scholarships when they confer right to purchase preferred seating at games); Rev. Rul. 67-246, 1967-2 C.B. 104 (regulating charitable contributions where benefit is conferred).

zations did not accurately inform their patrons of the extent to which contributions were deductible.¹²² In an attempt to remedy this situation, in 1988 the Internal Revenue Service sent to over 400,000 charitable organizations copies of Publication 1391, *Deductibility of Payments Made to Charities Conducting Fund-Raising Events*, which requested that charities be more forthright and informative toward patrons about the deductibility of contributions. Contained within the publication was a copy of Revenue Ruling 67-246, which provided a procedure for charities to utilize in accomplishing this purpose.¹²³ Congress, however, was still concerned that questionable charitable fundraising existed.¹²⁴ The provision, enacted as section 170(f)(8) of the Code,¹²⁵ is anticipated to yield additional tax revenues over five years of \$469,000,000 through a single information and disclosure reporting mechanism.¹²⁶

¹²² H.R. REP. NO. 391, 100th Cong., 1st Sess. 1608 (1987). In expressing their concern, Congress stated that it anticipated that the Internal Revenue Service will monitor the extent to which taxpayers are being furnished accurate and sufficient information by charitable organizations as to the nondeductibility of payments to such organizations where benefits or privileges are received in return, so that taxpayers can accurately compute their Federal income tax liability. *Id.*

¹²³ See Rev. Proc. 90-12, 1990-1, C.B. 471. The articulated purpose of Rev. Proc. 90-12 is "to provide charitable organizations with help in advising their patrons of the deductible amount of contributions under section 170 of the Code where the contributors are receiving something in return for their contributions. These guidelines will also be used by agents in determining whether charities have provided accurate information about deductibility to their contributors." *Id.* See generally INTERNAL REVENUE SERVICE, MANUAL SUPPLEMENT MS 7(10)G-59 (REV. 1), PART VII - EMPLOYEE PLANS AND EXEMPT ORGANIZATIONS, CHARITABLE SOLICITATIONS COMPLIANCE IMPROVEMENT STUDY (1991) (providing instruction to I.R.S. about study concerning fund raising and charitable solicitations); Chih-Chin Ho, *Form 990-T Compliance*, in INTERNAL REVENUE SERVICE RESEARCH BULLETIN, Pub. No. 1500, 47 (1992).

¹²⁴ See, e.g., H.R. 613, 104th Cong., 1st Sess., (1995) (establishing national clearinghouse for access to annual returns of exempt organizations); GENERAL ACCOUNTING OFFICE, BEFORE THE SUBCOMMITTEE ON NATIONAL ECONOMIC GROWTH, NATURAL RESOURCES AND REGULATORY AFFAIRS, COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT TAX-EXEMPT ORGANIZATIONS: ACTIVITIES AND I.R.S. OVERSIGHT, GAO/T-GGD-95-198 (1995); *March, 1994 Hearings*, *supra* note 62; *Hearings on Review of Federal Tax Laws Applicable to Public Charities Before the Ways & Means Oversight Committee*, 103d Cong., 1st Sess. 1603 (1993); *June, 1993 Hearings*, *supra* note 55.

¹²⁵ I.R.C. § 170(f)(8) (Supp. V 1993).

¹²⁶ See I.R.C. § 170(f)(8) (Supp. 1995); see also Temp. Treas. Reg. T.D. 8544, 59 Fed. Reg. 27458 (1994) (explaining § 170(f)(8) and soliciting public comment on whether transitional relief is required for 1994 contributions).

Substantiation rules focus on the deductibility of payments by the donor.¹²⁷ The general rule is that in order for a contribution to be deductible, donors must obtain a contemporaneous written acknowledgement from the donor organization if the contribution is \$250 or more.¹²⁸ A canceled check is no longer sufficient.¹²⁹ This acknowledgement must indicate the amount of money that was received by the donor, a description of whatever property was given, but not the value of such property, and a statement of whether or not any services or goods were provided in consideration for that payment, and if so, their value.¹³⁰

Although technically the donor is responsible for obtaining such substantiation,¹³¹ in practice, the burden falls on the charitable organization. If a charity fails to substantiate a contribution, such donor might be denied his/her deduction. Since this result could discourage further contributions on the donor's part, charities generally make every effort to ensure that the contributions are properly documented.¹³² If a charity wants the benefit of a subsidy not only of exemption from income tax but also of tax-deductible contributions it must be willing to comply with the substantiation rules,¹³³ as well as the disclosure rules,¹³⁴ un-

¹²⁷ I.R.C. § 170(f)(8)(A) (Supp. V 1993) ("no deduction shall be allowed ... for any contribution of \$250 or more unless the taxpayer substantiates the contribution.") See H.R. REP. NO. 111, 103d Cong., 1st Sess. 774, 784 (1993) (indicating that payment to charity from which donor receives economic benefit is only deductible to extent payment exceeds fair market value of benefit).

¹²⁸ I.R.C. § 170(f)(8)(A) (Supp. V 1993).

¹²⁹ I.R.C. § 170(f)(8)(B). An acknowledgement must include the amount of cash and description of any property, other than cash, contributed; whether the organization provided any goods or services in return for the contribution; and a description and good faith estimate of the value of the goods or services provided by the organization. *Id.* If the organization provided an "intangible religious benefit," defined as an intangible benefit "provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context", the donee must furnish a statement indicating that such a religious benefit was conferred. *Id.*

¹³⁰ See *supra* note 129.

¹³¹ I.R.C. § 170(f)(8)(A); see also Robert E. Fitzgerald, Jr., *Charitable Contributions—Canceled Checks to Substantiate the Contribution Under § 170 May No Longer Be Sufficient*, 50 J. MO. B. 171 (1994) (indicating that donor must request substantiation from charity; charity is not responsible for reporting this information to Internal Revenue Service for donor).

¹³² See Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1 (1994).

¹³³ Pub. L. No. 103-66 § 13172(a) provides that the substantiation rules of

der the Internal Revenue Code.

Charitable organizations are also required to make a good faith estimate of the value of any goods or services that are provided in connection with a *quid pro pro* contribution of more than \$75.¹³⁵ For example, if a charitable organization charges \$150 for a dinner, and the meal, in good-faith, can be valued at \$50, then the charity is required to indicate that \$100 is the total charitable contribution.¹³⁶

However, an exception is made for intangible religious benefits.¹³⁷ If such a benefit is part of the *quid pro pro*, a statement to that effect is required, but the valuation of the benefit conferred need not be included.¹³⁸ The Code defines an intangible religious benefit as any intangible benefit that is provided by an organization solely for religious purposes¹³⁹ and that generally is

I.R.C. § 170(f)(8) apply to contributions made on or after January 1, 1994. *See also* Carolyn C. Clark, *The Brave New World of Charitable Giving and Fund-Raising*, C968 A.L.I.-A.B.A. 249, 255 (1994) (stating that substantiation rules are intended to prevent taxpayers from exaggerating income tax charitable deductions).

¹³⁴ Section 13173(d) of Pub. L. No. 103-66 provides that I.R.C. § 6115 applies to *quid pro quo* contributions made on or after January 1, 1994. *See also* Clark, *supra* note 133, at 256 (stating that § 6115 places legal disclosure obligation on charitable organization).

¹³⁵ I.R.C. § 6115(b) (stating that *quid pro quo* contributions, payments made partly as contribution and partly in consideration for goods or services provided to payor by donee organization of \$75 or more, are subject to rule).

¹³⁶ *See* Clark, *supra* note 133, at 266-67 (providing an example where if Z, a public TV channel, provides contributors with autographed baseball with fair market value of \$200 in return for "contribution" of \$250. Z must provide statement informing donors that only \$50 is deductible for income tax purposes pursuant to § 6115); *see also* Fitzgerald, *supra* note 131 at 172-73. Fitzgerald agrees that it is the responsibility of the charity to furnish the donor with a written statement of the value of goods or services received, and to inform the donor that any deduction is limited to the amount of payment that exceed the value of goods and services provided).

¹³⁷ I.R.C. § 170(f)(8)(B)(iii). I.R.C. § 6115(b) states that "*quid pro quo* contribution does not include any payment made to an organization, organized exclusively for religious purposes, in return for which the taxpayer receives solely an intangible religious benefit that generally is not sold in a commercial transaction outside the donative context." *See e.g.*, Pamela F. Olson, *The Revenue Reconciliation Act of 1993: Provisions Applicable to Individuals, Excise Taxes, and Compliance*, Q225 A.L.I.-A.B.A. 47, 61 (1993) (stating that *quid pro quo* contributions do not include "intangible religious benefits").

¹³⁸ I.R.C. § 6115(b); *see also* Clark, *supra* note 133, at 258 (stating that if goods and services provided consist only of "intangible religious benefit," no valuation is required; mere acknowledgment of this fact is sufficient).

¹³⁹ "Solely for religious purposes" refers to organizations performing tasks for which a group exemption letter can be obtained. *See* Meade Emory & Lawrence Ze-

not sold in a commercial transaction outside the donative context.¹⁴⁰ Admission to a religious ceremony and wine served as part of the ceremony, are examples of intangible religious benefits.¹⁴¹

Religious organizations will no doubt feel the impact of the new substantiation and disclosure requirements. Similarly, proposals for intermediate sanctions will affect religious organizations.¹⁴² The statutory change for intermediate sanctions enjoys bi-partisan support, and a version of the Treasury proposals was passed by the House of Representatives on April 16, 1996, with Senate action possibly to come this Congressional Session. The Treasury proposed regulations on the substantiation and disclosure rules on August 4, 1995, and expects that final regulations will be issued before the end of 1996. Religious organizations need to continue to follow these important changes.

lenak, *The Tax Exempt Status of Communitarian Religious Organizations: An Unnecessary Controversy*, 50 FORDHAM L. REV. 1085 (1982) (discussing definition and application of "solely for religious purposes").

¹⁴⁰ I.R.C. § 6115(b).

¹⁴¹ See Clark, *supra* note 133, at 258 (providing examples of intangible religious benefits); Olson, *supra* note 137, at 53 (listing admission to religious ceremony as example of "intangible religious benefit").

¹⁴² See 103 Cong. Rec. E3057-01, E3057-58 (1993) (discussing how sanctions are modeled on private foundations and how they will affect religious organizations).